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SUBJECT: BOLIVARIAN REPUBLIC OF VENEZUELA: 2008 INVESTMENT CLIMATE STATEMENT

REF: 2007 STATE 158802

¶1. Per request in reftel, this cable transmits the 2008 Investment Climate Statement for the Bolivarian Republic of Venezuela.

Begin text

Openness to Foreign Investment

Given economic and political uncertainties, a recent history of actual and threatened expropriations, and increasing state intervention in the economy, Venezuela's investment climate is considerably less welcoming than its relatively liberal legal framework suggests. Foreign direct investment in Venezuela is much lower than in most other Latin American countries as a result of these factors. On the other hand, many companies with existing investments in Venezuela are recording strong profits thanks to four consecutive years of high economic growth fueled by record oil prices and massive government spending.

Important developments in 2007 included expropriation of key companies and assets in telecommunications, electricity, and petroleum sectors, which were previously considered the most promising areas for foreign investment in Venezuela. Expropriations in each sector included significant assets owned by U.S. companies, some of which received compensation. During 2007, President Chavez also threatened to expropriate companies in the banking, cement, health, education, steel, petrochemical, dairy, and food distribution sectors. The government also revoked or refused to renew important concessions in the tourism industry previously held by private companies.

As part of his push toward "21st Century Socialism," President Chavez proposed in August 2007 a series of constitutional reforms that would have, among other things, defined Venezuela as a socialist state and significantly weakened protections for private property. While voters rejected these proposals by a slim margin in a December 2007 referendum, President Chavez has stated his intention to continue to pursue them.

Growing state intervention in the economy has created a series of distortions. The Venezuelan government, abbreviated hereafter as the BRV (Bolivarian Republic of Venezuela), has maintained a fixed exchange rate and exchange controls since February 2003. The official bolivar/dollar exchange rate is clearly overvalued thanks to

accumulated inflation of over 50 percent since the rate was last adjusted in March 2005. As a result, there is intense competition to gain access to hard currency at the official rate (including for repatriation of capital and/or profits), and rationing of official dollars has led to the development of a parallel foreign exchange market. The BRV also maintains price controls on a wide variety of goods and services. These controls have caused shortages and have created disincentives to investment, in some cases driving companies that produce price-controlled goods out of business.

Venezuela's legal framework for foreign investment, on the other hand, is relatively liberal. Outlined in further detail below, it generally provides equal treatment to foreign and local companies, with the exception of several sectors, including hydrocarbons and media, in which the state or Venezuelan nationals must be majority owners. Repatriation of capital and dividends is allowed, subject to the exchange control regime.

Legal Framework for Foreign Investment

The 1999 Constitution

The Venezuelan Constitution of 1999 treats capital investment as a means of promoting the development of the national economy. Article 301 of the Constitution adopts international standards for the treatment of private capital, with equal treatment of local and foreign capital. The Constitution reserves strategic sectors such as oil and hydropower for the State.

Decree 2095

Decree 2095 of 1992 establishes the legal framework for foreign

investment in Venezuela. This decree implemented Andean Community Decisions 291 and 292 and lifted most prior restrictions on foreign participation in the economy. (Venezuela withdrew from the Andean Community in April 2006, but the BRV has continued to apply most Andean Community norms in the absence of any other regulations.) Article 13 of the decree explicitly guarantees foreign investors the same rights and imposes the same obligations as apply to national investors "except as provided for in special laws and limitations contained in this Decree." Decree 2095 also guarantees foreign investors the right to repatriate 100 percent of profits and capital, including proceeds from the sale of shares or liquidation of a company, and allows for unrestricted reinvestment of profits.

Under Decree 2095, foreign investors need only register with the Superintendent of Foreign Investment (SIEX) within 60 days of the date a new investment is made. Foreign companies may generally open offices in Venezuela without prior authorization from SIEX as long as they do not engage in certain sales or business activities that would require registration. No prior authorization is required for technical assistance, transfer of technology, or trademark-use agreements, provided they are not contrary to existing legal provisions.

Decree 2095 reserves three areas of economic activity to "national companies": (1) broadcast media, (2) newspapers, and (3) professional services that are regulated by national laws. These services include law, architecture, engineering, medicine, veterinary medicine, dentistry, economics, public accounting, psychology, pharmacy, and management. A "national company" (as defined in Article 1 of Andean Community Decision 291) is a company in which Venezuelan nationals hold more than 80 percent of the equity. Foreign capital is therefore restricted to a maximum of 19.9 percent in the areas noted above. The Investment Promotion and Protection Law of October 1999, whose regulations were published in July 2002, maintained the same reserved sectors.

Foreign professionals are free to work in Venezuela without restriction but must first revalidate their certification at a Venezuelan university. Consulting services under contract for a specific project are not subject to this requirement.

The Hydrocarbons Sector

A number of sectors are regulated by "special laws" that supplement the Constitution and affect the business environment. These sectors

include hydrocarbons, mining, telecommunications, banking, and insurance. Of these, it is the hydrocarbons sector in which there are significant restrictions on foreign investment.

The 2001 Hydrocarbons Law reserves to the state the exploration, production, "gathering," and initial transportation and storage of petroleum and associated natural gas. Under this regime, primary activities must be carried out directly by the state, by a 100 percent state-owned company such as Petroleos de Venezuela (PDVSA), or by a joint venture company with more than 50 percent of the shares held by the state. The law left refining ventures open to private investment as well as commercialization activities, under a license and permit regime. It also stipulated that any arbitration proceedings would henceforth be in domestic not international venues.

Over the last several years the BRV has made a number of changes in royalty, tax policies, and contracts that have substantially increased uncertainty for foreign companies operating in Venezuela. The Hydrocarbons Law did not specifically grandfather contracts executed under earlier legislation, specifically the 33 operating service contracts awarded for "marginal" or inactive oilfields in three rounds in the 1990s; exploration and production profit-sharing agreements awarded in 1996; and four so-called "Strategic Associations," legal entities with majority private and minority PDVSA ownership formed in the 1990s to extract and upgrade Venezuela's extra heavy oil in the Faja region. The BRV argued in 2001 that no grandfather provision was necessary because retroactive application of legislative provisions is forbidden by constitutional mandate.

In October 2004, however, the BRV unilaterally eliminated a nine-year royalty holiday ceded to the Strategic Associations, arguing that this was allowable under earlier hydrocarbons legislation. The BRV then

informed companies with operating contracts in early 2005 that they must migrate the contracts to joint ventures that conform to the 2001 Hydrocarbons Law. It threatened to seize fields operating under the services contracts on December 31, 2005 if oil companies did not sign transition agreements to migrate their contracts. Sixteen oil companies signed memorandum of understanding converting their contracts to joint ventures on March 31, 2005. Two companies, ENI and Total, did not sign a MOU, and PDVSA took control of their fields.

President Chavez issued a decree in late February 2007 requiring the four strategic associations to convert to joint ventures in which PDVSA would hold a 60 percent stake. The decree established an April 30, 2007 deadline for completing the conversion. ConocoPhillips and ExxonMobil refused to migrate their investment stakes in three of the four associations. As a result, the BRV took control of their investments. Both companies are treating the government's actions as expropriations. They have filed arbitration claims against the BRV and are continuing to negotiate compensation.

In contrast to the legal framework for petroleum, the 1999 Gaseous Hydrocarbons Law offers more liberal terms to investors in the unassociated natural gas sector. This law opened the entire natural gas sector to private investment, both domestic and foreign, and created a licensing system for exploration and production regulated by the Ministry of People's Power for Energy and Mines. The state retains ownership of all natural gas "in situ", but PDVSA involvement is not required for gas development projects. Complete vertical integration of the gas business from wellhead to consumer is prohibited. President Chavez has publicly stated, however, that he would like to modify the terms of the 1999 law, i.e. to require that the state have a controlling interest in primary unassociated natural gas activities.

Conversion and Transfer Policies

Foreign investors in capital markets and foreign direct investment projects are guaranteed the right to repatriate dividends and capital under the Constitution and Decree 2095. In practice, however, repatriation poses problems for many companies.

The Law Governing the Foreign Exchange System (Gazette No. 4897 of 1995) permits the executive branch to intervene in the foreign exchange market "when national interests so dictate." President Chavez used this law to create the Commission for the Administration of Foreign

Exchange (CADIVI) on February 5, 2003 to regulate the purchase and sale of foreign currency. A Foreign Exchange Crime Law (Gazette No. 38,272 of 2005; revised by the National Assembly in December 2007) established criminal penalties and fines for transactions made outside the official foreign exchange process. The exemption for bond operations in this law has led to the creation of a parallel foreign exchange market, known as the "permuta" (swap) market, which is essentially a currency exchange market that operates through bond swaps.

The official exchange rate was adjusted to 2150 bolivars (Bs) to the dollar in March 2005. With accumulated inflation of over 50 percent since this adjustment, the official exchange rate is clearly overvalued, and companies that manufacture tradable goods in Venezuela find it very difficult to compete against goods imported at the official rate. Although government officials have emphatically stated there will be no devaluation in 2008, many economists predict either a devaluation or the introduction of a dual exchange rate system. The parallel market is relatively shallow and volatile; it closed 2007 at 5700 Bs/USD. As of January 1, 2008, the government began to introduce a redenominated bolivar known, during the transition period, as the "bolivar fuerte." 1000 old bolivars are worth 1 new bolivar (or "bolivar fuerte"); the official exchange rate became 2.15 bolivars (fuerte) to the dollar. Both old and new bolivars will circulate during the transition period, which will last a minimum of six months.

Foreign companies wishing to repatriate capital, dividends, or profits at the official rate have to get authorization from CADIVI. In 2007, CADIVI authorized over USD 3.3 billion in repatriations. However many companies did not receive the full authorization they requested from CADIVI or received it after delays of six months or more. Some companies have therefore turned to the parallel market for

repatriation.

Expropriation and Compensation

The government has expropriated significant assets in recent years. Given President Chavez' threats to various sectors, this trend is expected to continue. The largest expropriations in 2007 were the nationalizations of CANTV and Electricidad de Caracas (EDC), the seizure of the assets of Radio Caracas Television (RCTV), and the conversion of the Faja heavy oil strategic associations to joint ventures. In the cases of CANTV and EDC, the government paid compensation to shareholders including U.S. companies Verizon (which owned 28 percent of CANTV) and AES Corporation (which owned 82 percent of EDC). In the case of RCTV, a privately held Venezuelan company, the government has not paid compensation for the assets seized. As noted above, ConocoPhillips and ExxonMobil have not come to agreement with the BRV for the expropriation of their respective investments in the strategic associations. They have filed for arbitration and are continuing to negotiate with the BRV.

Venezuela's 2001 land law as modified in 2005 calls for the redistribution of "unproductive" land. The BRV claims to have seized 4.7 million acres of land since 1998; some of this land was expropriated without compensation. These actions have discouraged investment in several key agricultural subsectors and reduced their output potential.

On February 21, 2007, the BRV published the "Decree Law of Popular Defense against hoarding, speculation, boycott, and any other conduct that affects consumption of food or products under price controls." The law defines all stages of the production cycle for regulated foods as within the ambit of "public utility and the social interest." It also empowers the government to expropriate any business that fits this sweeping definition in order to protect "food security and sovereignty." The BRV invoked this decree to direct the military to seize two slaughterhouses in 2007.

Dispute Settlement

Venezuela's legal system is available to foreign entities seeking to resolve investment disputes, and legal proceedings have generally not discriminated against foreign entities. However, the legal system is

often slow and inefficient, and it has been accused of being both corrupt and lacking independence from the executive branch.

Decree 2095 allows for the arbitration of disputes as "provided by domestic law." The Commercial Arbitration Law (Gazette No. 36,430 of 1998) eliminated the previous requirement for judicial approval of arbitration; arbitration agreements involving national or international firms can therefore be automatically binding. The law also allows state enterprises to subject themselves to arbitration in contracts with private commercial entities, but requires that they first obtain the approval of the "competent statutory body," as well as the "written authorization" of the responsible minister. As noted above, however, the 2001 Hydrocarbons Law prohibits PDVSA from entering into agreements providing for international arbitration. The BRV has in the past accepted the results of international arbitration in disputes involving foreign investors and government entities. Recent BRV statements and actions, however, call into question whether this trend will continue. For example, in a February 2006 decision involving Haagen-Dazs, BRV courts invalidated an American Arbitration Association award entered in Miami. In April 2006, a BRV court set aside an International Court of Arbitration award entered in favor of an Italian electronics company against VTV, the state owned television channel, in connection with a concession agreement.

Performance Requirements and Incentives

Foreign companies receive the same tax treatment as domestic companies with the exception of the non-associated natural gas sector, where

foreign investors receive preferential tax treatment. Performance requirements related to workforce composition are discussed in the labor section below. There are allegations that CADIVI is requiring companies to make investments in specific geographic areas as a condition to receive hard currency allocations. The state oil company, PDVSA, seeks to maximize local content and hiring in its negotiations with foreign companies.

Right to Private Ownership and Establishment

There are no legal limits on foreign ownership, except as noted in the Constitution, Decree 2095, and "special laws" (see above).

Protection of Property Rights

Real Property Rights

Foreign investors may pursue property claims through Venezuela's legal system. See also the Expropriation and Compensation section for discussion of expropriation of real property rights and the Dispute Settlement section for a discussion of the legal system.

Intellectual Property Rights

Article 98 of the 1999 constitution guarantees state protection for intellectual property rights "in accordance with the conditions and exception established by law and the international treaties executed and ratified by the Republic in this field." Venezuela is a signatory to the Berne Convention for the Protection of Literary and Artistic Works, the Geneva Phonograms Convention, the Universal Copyright Convention, and the Paris Convention for the Protection of Industrial Property. Although Venezuela is a member of the World Intellectual Property Organization (WIPO), no official BRV delegation has attended a WIPO meeting in the last four years. Venezuela implements its obligations under the WTO Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS) through Andean Community Decision ¶486. (As noted above, Venezuela has withdrawn from the Andean Community but the BRV continues to apply most Andean Community norms in the absence of any other regulations.)

The Venezuelan Industrial Property Office (SAPI), through its actions and occasional public antagonism towards IPR, often draws criticism from IPR advocates and rights holders. IPR protection is also hindered

by the lack of adequate resources for the Venezuelan copyright and trademark enforcement police (COMANPI) and for the special IPR prosecutor's office. SAPI has publicly advocated for anti-IPR legislation and has not issued a pharmaceutical patent since 2004. Pirated software, music, and movies are readily available throughout the country. In the 2007 Special 301 Annual Review, Venezuela remained on the "Priority Watch List."

Patents and Trademarks

Venezuela provides the legal framework for patent and trademark protection through Andean Community Decision 486 (and Decision 345 for plant varieties). The Andean Tribunal's 2002 interpretation of Articles 14 and 21 of Decision 486 does not allow for the patenting of "second-use" products (e.g. new uses of previously known or patented products). Under pressure from the Andean Community and in line with some changes in leadership at SAPI, Venezuela has revoked previously issued patents.

Very few patents for new pharmaceuticals were awarded in 2004 and none were issued in 2005, 2006, or 2007. Since 2002 Venezuela's food and drug regulatory agency has approved the commercialization of generic drugs without requiring unique test data. These drugs are the bioequivalent of innovative drugs that already received market approval. This practice thereby denies the innovative drug companies protection against unfair use of their test data as required by TRIPS.

Venezuela does not automatically recognize foreign patents, trademarks or logotypes, so foreign investors must be sure to register patents and

trademarks appropriately and in as many categories as are applicable. It is advisable not to have agents or distributors do so because the agent can then claim that he/she is the registered owner of the trademark in question.

Copyrights

Andean Community Decision 351 and Venezuela's 1993 Copyright Law provide the legal framework for the protection of copyrights. The 1993 Copyright Law is modern and comprehensive and extends copyright protection to all creative works, including computer software. A National Copyright Office was established in October 1995 and given responsibility for registering copyrights, as well as for controlling, overseeing and ensuring compliance with the rights of authors and other copyright holders.

COMANPI, the Venezuelan copyright and trademark enforcement branch of the police, fails to provide adequate copyright enforcement. Due to its lack of personnel, limited budget, and inadequate storage facilities for seized goods, COMANPI has had to work with the National Guard and private industry to enforce copyright laws. COMANPI can only act based on a complaint by a copyright holder; it cannot carry out an arrest or seizure on its own initiative. The BRV's tax authority (SENIAT) has been more successful enforcing IPR laws. It has taken action against some businesses importing or selling pirated goods on the basis of presumed tax evasion.

Since 2004, the National Assembly has also been considering a Copyrights bill. The bill, which was proposed by SAPI, has been very controversial and raised serious concerns in the private sector. Among other things, the bill calls for the local registration of all works, certification by a government-appointed commission to approve the copyright, a significant increase in royalty rates, and a provision to expropriate works if in the national interest. Had ChavezQ December 2007 constitutional reform package passed, it was rumored that the bill would have been issued via presidential decree.

Transparency of Regulatory System

The Government of Venezuela adopted three laws in the early 1990's to promote free market competition and prevent unfair trade practices: a Law to Promote and Protect Free Competition (Gazette No. 34,880 of 1992), an Antidumping Decree (Gazette No. 4441 of 1992), and a Consumer Protection Law (Gazette No. 4898 of 1995). In 1997 the government created a new agency, Pro Competencia, to implement the 1992 law. A government procurement law of 2001 supposedly increased transparency in

the competitive bidding process for contracts offered by the central government, national universities, and autonomous state and municipal institutions.

Despite this legal and institutional framework, there is little transparency in Venezuela's regulatory system. The vast majority of contracts are awarded without open competition. There is often little coordination between the government and private sector, and even among different government agencies, in the process of promulgating new laws.

As a result of this lack of coordination and the state's increasing intervention in the economy, many companies are struggling to cope with the growing array of regulations in areas as diverse as the tax code, labor, and the environment.

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Efficient Capital Markets and Portfolio Investment
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Capital Markets

Access to the Venezuelan secondary capital market is relatively easy, and foreign firms essentially enjoy treatment equal to that of domestic firms. Foreign companies may issue common and preferred stocks, bonds, and other securities in Venezuelan capital markets. Foreign investors may also buy shares directly in Venezuelan companies or on the Caracas Stock Exchange.

A Capital Markets Law (Gazette No. 36,565 of 1998) gave autonomy to the National Securities Commission and provides regulations for intermediaries, establishes new conditions for public offerings, enhances the transparency of brokerage operations, and makes regulations more flexible for small firms that wish to issue stocks. The Collective Investment Entities Law (Gazette No. 36,027 of 1996) allows for creation of collective investment companies such as mutual funds, collective investment venture capital companies, and collective real estate investment companies.

Credit Markets

Financing is available from a variety of sources, and there is no discrimination against foreign investors seeking access to credit. The credit market is highly regulated, however. The maximum nominal interest rate banks can charge is 28 percent. Banks are required to set aside 34 percent of their portfolio for loans to the housing, agriculture, small business, and tourism sectors, in some cases at preferential rates.

Thanks to several years of sustained economic growth and to the high liquidity generated by exchange controls, the banking sector's financial soundness indicators were generally strong as of December ¶2007. However the banking sector is highly exposed to the public sector through government deposits and bond holdings, some banks have a large percentage of their portfolio in consumption loans, and some banks are pushing the limits of capital adequacy requirements. The majority of banking sector assets are concentrated in the country's six largest banks.

Political Violence

Venezuela's political climate is polarized between supporters and opponents of President Chavez and his policies. This polarization resulted in several periods of political protests and mild civil unrest in Venezuela during 2007, one immediately following the May 28 closure of RCTV and one in the run-up to the December 2 constitutional referendum. There were no major incidents of political violence targeted against foreign-owned companies or installations.

Corruption

Corruption is a very serious problem in Venezuela and appears to be worsening. According to Transparency International's Corruption Perceptions Index, Venezuela is the second most corrupt country in Latin America and one of the most corrupt in the world. Venezuela has

laws on the books to prevent and prosecute corruption, and accepting a bribe is a criminal act. However, the judicial system has been ineffective historically and is accused of being overtly politicized. Government contracts are vulnerable to corruption because the tender process frequently lacks transparency. The current regime of price and foreign exchange controls has also provided opportunity for corruption.

Bilateral Investment Agreements

Venezuela currently has bilateral investment agreements in force for the promotion and protection of investment with the following countries: Argentina, Barbados, Belgium-Luxemburg, Brazil, Canada, Chile, Costa Rica, Cuba, the Czech Republic, Denmark, Ecuador, France, Germany, Iran, Lithuania, Netherlands, Paraguay, Peru, Portugal, Spain, Sweden, Switzerland, the United Kingdom and Uruguay. No agreement exists with the United States.

OPIC and Other Investment Insurance Programs

OPIC programs in Venezuela were suspended in 2005 as a result of Venezuela's decertification for failure to cooperate in suppressing international narcotics trafficking. The certification process is an

annual event, and the most recent determination (September 2007) also decertified Venezuela. The Export-Import Bank has not provided new financing for projects in Venezuela since formally placing Venezuela "off cover" for new lending in April 2003. Both OPIC and the Ex-Im Bank currently have significant exposure in Venezuela contracted prior to suspending operations.

Labor

Venezuela's National Institute of Statistics (INE) estimated unemployment at 6.3 percent as of November 2007. While this rate would suggest some availability of labor, several factors make human resources a challenge for domestic and foreign investors alike. Even as rapid economic growth has increased the demand for labor, a significant number of skilled and professional Venezuelans have sought employment opportunities abroad due to domestic political and economic uncertainty. At the same time, government programs that support poorer Venezuelans have also made it more difficult for companies to attract unskilled labor. The BRV has extended a freeze on layoffs through December 2008 with the possibility of further extension, one of several measures that have decreased labor market flexibility. The power of trade unions has generally diminished during President Chavez's tenure, although they are still active in certain sectors.

The Organic Labor Law (Gazette No. 5152 of 1997) places quantitative and total wage cost restrictions on the employment decisions made by foreign investors. Article 27 requires that the number of foreigners hired by an investor not exceed 10 percent of a company's employees, while salaries paid to foreigners may not exceed 20 percent of the total company payroll. Article 28 allows for temporary exceptions to Article 27 and outlines the requirements for hiring technical expertise when equivalent Venezuelan personnel are not available. Article 20 of the law requires that industrial relations managers, personnel managers, captains of ships and airplanes, and foremen be Venezuelan.

Foreign-Trade Zones/Free Ports

The Free-Trade Zone Law (Gazette No. 34,772 of 1991) provides for free trade zones/free ports. The three existing free trade zones, created in subsequent Gazette decrees, are located in the Paraguana Peninsula on Venezuela's northwest coast, Atuja in the State of Zulia, and Merida (but only for cultural, scientific, and technological goods). These zones provide exemptions from most import and export duties and offer foreign-owned firms the same investment opportunities as host country firms. The Paraguana and Atuja zones provide additional exemption of local services such as water and electricity. Venezuela has two free ports that also enjoy exemptions from most tariff duties: Margarita

Island (Nueva Esparta) and Santa Elena de Uairen in the state of Bolivar.

Foreign Direct Investment Statistics

The stock of U.S. foreign direct investment (FDI) in Venezuela in 2006 was USD 11.5 billion on a historical-cost basis according to U.S. Department of Commerce statistics. U.S. FDI in Venezuela is concentrated largely in the petroleum, manufacturing, and finance sectors. Note that these figures, the most recent available, do not include changes to the stock of U.S. FDI in Venezuela as a result of the 2007 expropriations.

According to the Central Bank of Venezuela, the net flow of FDI into Venezuela was USD 317 million in the first nine months of 2007, and the net flow of FDI from Venezuela to other countries was USD 3 billion over the same period. The FDI inflow to Venezuela represents roughly 0.2 percent of Venezuela's GDP, compared with the Latin American average of roughly 2.5 percent of GDP.

End text
DUDDY